What have central banks from EMEs learnt about the international transmission of monetary policy in recent years?

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Abstract

After the Fed adopted its unconventional monetary policy, countries with strong surpluses faced fewer challenges than did those with more open economies and strong financial linkages with developed economies. In the case of Saudi Arabia, fiscal policy remains dominant due to the structure of the economy and the country's exchange rate arrangements. As a result, Saudi Arabia did not have to engage in FX intervention to defend its currency or impose additional macroprudential measures to maintain the stability of the domestic financial system.

Keywords: Financial crises, Fed, unconventional monetary policy, EMEs, current account, exchange rate, and capital flows

JEL classification: E52, E58, F31, G01, E62

1. Introduction

The past two decades have witnessed a number of financial crises, but the latest one in 2008 was the most severe in modern history. Coordinated actions from many countries were needed to alleviate its impact on the global economy with significant pressures on central banks to restore financial stability and avert a potential deflationary spiral. Central banks in the advanced economies have resorted to unconventional policy tools, as lower-bound interest rates have reduced the effectiveness of monetary policy.

2. Impact of central bank actions on EMEs

The Fed has led other major central banks in pursuing unconventional monetary measures aggressively. Asset purchases have approximately quadrupled the size of the Fed's balance sheet since the beginning of crisis in a bid to keep mortgage rates low and help stabilise the financial system in the aftermath of the crisis. The Fed's policy triggered massive capital inflows into EMEs, putting undue upward pressure on their currencies and asset prices. Some countries have criticised QE as opening the way to currency wars and have been forced to introduce temporary capital controls. The flip side of this episode is that the Fed's exit strategy, initially by gradually withdrawing monetary stimulus via reduced asset purchases (so-called tapering), is also a matter of serious concern to EMEs as it has caused abrupt capital outflows and undermined their exchange rates.

The impact of policy transmission on EMEs varies according to their economic fundamentals. Countries with good current account surpluses were less vulnerable whereas those with more open economies and strong financial linkages with developed economies have suffered the most.

3. Saudi Arabia's experience

In Saudi Arabia, fiscal policy remains dominant due to the structure of the economy and the country's exchange rate arrangements. As for monetary policy transmission in Saudi Arabia, the most effective policy channel is the credit channel due to the constraints on interest rate policy under a fixed exchange rate regime.[1] Bank credit growth in Saudi Arabia reflects the economic activities stemming from fiscal operations (ie government spending on infrastructure projects). After a pause in 2009, bank credit growth has remained largely in line with overall economic activity. Unlike some other EME central banks, SAMA did not have to engage in FX intervention to defend the currency nor did it impose additional macroprudential measures to maintain the stability of the domestic financial system. This was largely

[1] Saudi Arabian Monetary Authority (SAMA) seeks to ensure that monetary and exchange rate policies are mutually consistent. In cases where speculation on the Saudi riyal is expected, SAMA either lets the interest rate differential widen to make speculation more expensive, or it intervenes in the FX market to mitigate any speculation-linked volatility in the rarely used forward market.

due to the resiliency of the Saudi banks, which derives from their strong balance sheets and prudent risk management together with sound supervision. Given that effective banking supervision lies at the core of financial stability, SAMA takes a proactive approach in supervising Saudi banks through rule-based as well as macroprudential measures. The bottom line is that Saudi banks' financial ratios speak for themselves, with regulatory capital well above the Basel II and III minimum requirements, while liquidity and leverage ratios are relatively conservative.

4. Lessons learnt about monetary policy transmission

- Owing to the nexus between monetary policy and capital flows, EMEs are more sensitive to any volatility in capital flows that may be triggered by major central bank policy actions.
- EMEs need to be better prepared to contain the impact of global crisis. Rather than adopting a bank-centric approach, this implies further developing their domestic capital markets with a view to making better use of domestic savings and improving their capacity to absorb capital flows from DMEs.
- Countries with structural issues need to introduce fiscal discipline in good times and to address supply-side shocks with the aim of reducing the volatility of their growth path.
- A sound and stable financial and banking system is the key to economic growth and to withstanding crisis-related effects.
- Capital controls should be the last resort and of short duration as they interfere with optimal asset allocation.